SURREY COUNTY COUNCIL

PENSION FUND COMMITTEE

DATE: **16 JUNE 2023**

LEAD OFFICER: **ANNA D'ALESSANDRO, DIRECTOR CORPORATE FINANCIAL & COMMERCIAL**

SUBJECT: **INVESTMENT MANAGER PERFORMANCE AND ASSET/LIABILITIES UPDATE**

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SUMMARY OF ISSUE:

This report is a summary of manager issues for the attention of the Pension Fund Committee (Committee), as well as an update on investment performance and the values of assets and liabilities.

RECOMMENDATIONS:

It is recommended that the Committee:

Notes the main findings of the report in relation to the Fund's valuation and funding level, performance returns and asset allocation.

REASON FOR RECOMMENDATIONS:

To assess and acknowledge performance of the Fund's investment managers against the Fund's target returns, and whether it is meeting its Strategic Investment objective in line with the Business Plan.

DETAILS:

Funding Level

1. The funding level is derived as the ratio of the value of the Fund's assets to the value of its liabilities. The Fund's liabilities are the future benefit payments due to members in respect of their service accrued in the Fund. The Fund's assets are used to pay member benefits accrued to date.

2. For the purpose of providing the quarterly funding updates following the 2022 valuation, it is appropriate (and the Fund Actuary's recommendation) that the 70% level of prudence remains fixed in the determination of the discount rate. This 'dynamic' discount rate each quarter-end would therefore reflect the change in investment return expectations since the 2022 valuation date.

3. Assessing the liabilities using the 'dynamic' discount rate also ensures that the factors leading to a change in asset values are being reflected in liability values. There is not a direct relationship (ie assets and liabilities do not react in the exact same way to changes in market conditions) but measuring the liabilities using the 'dynamic' discount rate means that the assets and liabilities are being measured on a consistent market basis over time.

4. Results and assumptions

	31 March 2022	30 December 2022	31 March 2023
Assets (£m)	5,358	5,074	5,260
Past service liabilities (£m)	5,257	4,080	4,150
Surplus (£m)	**101**	**994**	**1,110**
Funding level	102%	124%	127%
Discount Rate	4.4%	6.2%	6.0%
Salary Increases	3.7%	3.2%	3.3%
Pension Increases	2.7%	2.2%	2.3%
Likelihood of success	70%	70%	70%

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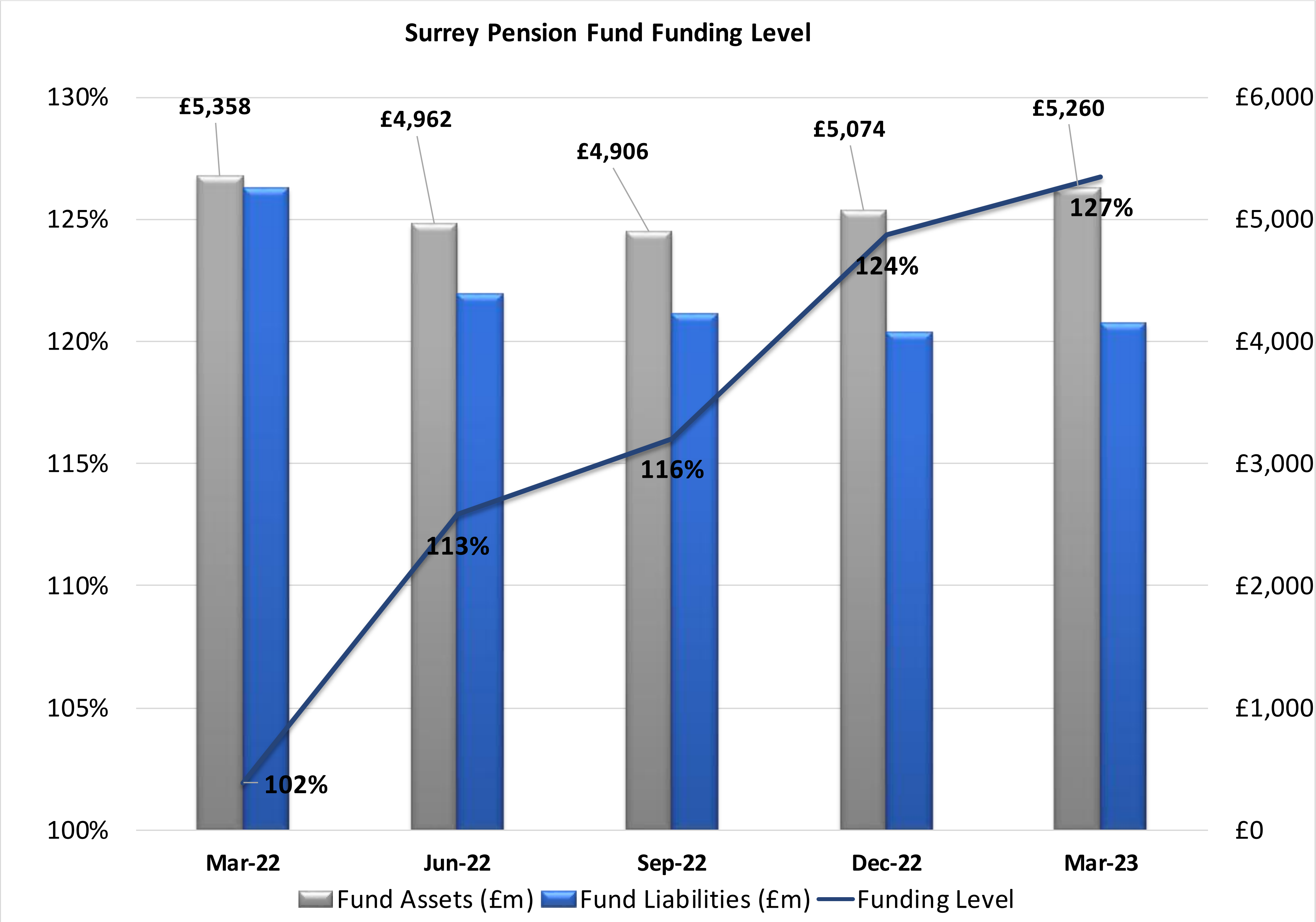
5. The discount rate assumptions at each date are based on the return expected from the Fund's assets with a 70% likelihood i.e., based on our asset return expectations as at 31 March 2023, there is an 70% likelihood that the Fund's assets will generate returns over the next 20 years at the level of at least 6.0% per annum.

6. The funding level has increased since that reported at the 2022 valuation. Liability values have fallen since 31 March 2022 by c. 20% - 25% due to an increase in the assumed level of future investment returns (the discount rate) which has been driven, in part, by a significant rise in long dated gilts yields over the period from 31 March 2022 to 31 March 2023. The value of the assets as at 31 March 2023 is lower than that as at 31 March 2022, due to negative asset returns (Fund return over the period is estimated to be c. -1.8%), which has acted to offset the reduction in the liabilities due to higher assumed investment returns. The net position has therefore improved from a surplus of £101m at 31 March 2022 to a surplus of £1.11bn at 31 March 2023. The estimated investment return for Q1 2023 (Q4 Fiscal Year) has been estimated based on the change in the whole Fund asset value over this quarter.

7. The graph below shows that funding level has reached 127% (102% as at 31 March 2022), updated for market conditions at 31 March 2023. The market value of assets is approximately £5.3bn and the value placed on the liabilities is £4.2bn.


Surrey Pension Fund Funding Level
130%
125%
120%
115%
110%
105%
100%
£6,000
£5,000
£4,000
£3,000
£2,000
£1,000
£0
£5,358
£4,962
£4,906
£5,074
£5,260
102%
113%
116%
124%
127%
Mar-22
Jun-22
Sep-22
Dec-22
Mar-23
Fund Assets (£m)
Fund Liabilities (£m)
Funding Level

8. Global equities rose over the quarter ended 31 March 2023. US equities were up despite being impacted late in the quarter by the collapse of Silicon Valley Bank (SVB) and Signature Bank. Markets recovered after intervention from policymakers and takeovers by more secure banks. The US Federal Reserve hiked interest rates by 25 bp twice, although signalled that the pace of increases is likely to soften. Inflation continued to fall and hit its lowest rate since September 2021 in February, whilst the US labour market softened slightly. UK equities were up for the quarter but lagged global markets. In continued attempts to curb inflation, the Bank of England increased interest rates by 25bps twice, but recession was avoided by a small increase in GDP. Composite Purchasing Managers Index readings improved over the quarter, driven mainly by strong performance from the services sector in February, but both services and manufacturing fell back slightly in March. European (ex UK) equity markets outperformed global equities despite also being affected by volatility in the banking sector, which saw Credit Suisse subjected to a forced takeover by UBS. The European Central Bank raised interest rates by 50bps in both February and March. Headline inflation fell in March, primarily due to lower energy prices; however, core inflation rose to a record high. Japanese equities rose, performing broadly in line with global markets, although the economy stagnated. Asia Pacific (ex-Japan) and emerging market equities also rose marginally, boosted by China's economic re-opening, though both lagged global markets.

9. Global government bonds fluctuated over the first quarter of 2023, but yields on UK, US, German and Japanese government bonds all ultimately fell (and so prices rose) over the period. This reflected the hope that the end to the rate hiking cycle may be in sight. The Fed's target range at the end of the period was 4.75-5%, 3.5% for the European Central Bank (ECB) and 4.25% for the Bank of England. Whilst yields on 10-year UK gilts decreased over the quarter, yields spiked in early March after annual inflation unexpectedly rose to 10.4% in February as food shortages pushed up grocery prices. The Bank of Japan maintained its interest rates throughout the period despite inflation rising to a 41-year high of 4.3% in January.

10. Yields on global credit fell in the quarter, mirroring the fall in government bond yields. However, credit spreads widened given recession fears and elevated concerns over the US and European banking sectors.

11. The US dollar fell overall against both sterling and the euro during a volatile quarter. March saw the US currency strengthen against European currencies as investors sought a safer haven in the wake of bank collapses. However, it dipped again once policymakers and larger banks intervened to stabilise the sector. Sterling recovered against the dollar and rose slightly against the yen but fell against the euro. Gains against the dollar were driven by the Bank of England signalling that it 9. would continue to raise interest rates to curb inflation.

12. The economic and interest rate environment described above is clearly not helpful for Real Estate markets and capital values have been significantly negatively impacted. More recently, capital values across the whole market in the UK have turned positive, driven by the retail and industrial sectors. In contrast, the office sector recorded its ninth month of falling capital values, bringing the cumulative decline in the sector to 18% since the peak of the market in June 2022. These capital value declines were driven by yield movements. To date in the UK, there has been limited impact on the occupier side, with rental growth remaining resilient at the end of 2022 and into 2023, particularly in sectors underpinned by structural and demographic trends such as logistics and residential. Liquidity in the market was at its lowest point since 2009 in the second half of 2022, with debt-driven buyers mostly absent. It has begun to recover in 2023, but with the cost of debt still elevated, transactional activity is mostly in the smaller lot size end of the market. These trends have been mirrored around the world given the synchronised upward movement in interest rates.

13. Overall, the Fund returned 3.39% in Q4 2022/23 (Jan-Mar 2023), in comparison with the benchmark of 3.59%.

14. The best absolute performance came from the exposure to European and Global equities, but all equity and bond funds were in positive territory, except for BCPP Listed Alternatives, which continues to perform poorly, both absolutely and relative to benchmark. This fund has been negatively impacted by the rise in interest rates and the sizable positioning towards real estate. All the other actively managed equity and fixed income funds outperformed their benchmarks over the period and BCPP Global Equity Alpha is now ahead of target over 3 years.

15. The real estate sector has been going through a period of re-pricing, reflecting increased debt funding costs, and low transactional activity. This impact was seen through the CBRE holding, particularly over the last 12 months, as well as Listed Alternatives. Rental income has remained resilient and capital values are now more firmly underpinned by higher starting yields. 8

16. Private market values were relatively flat and hence underperformed the rising listed equity markets.

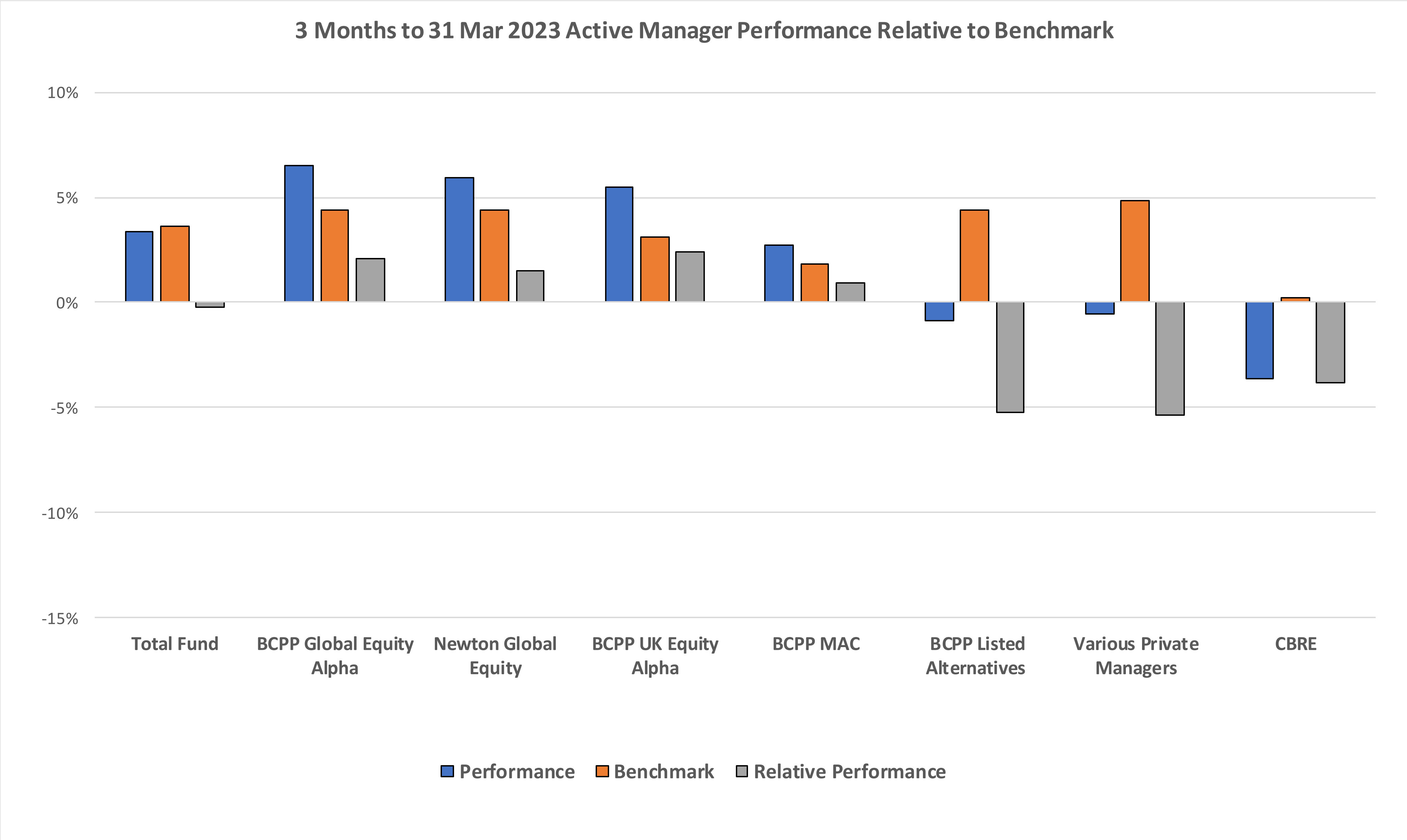
Fund Performance - Summary of Quarterly Results

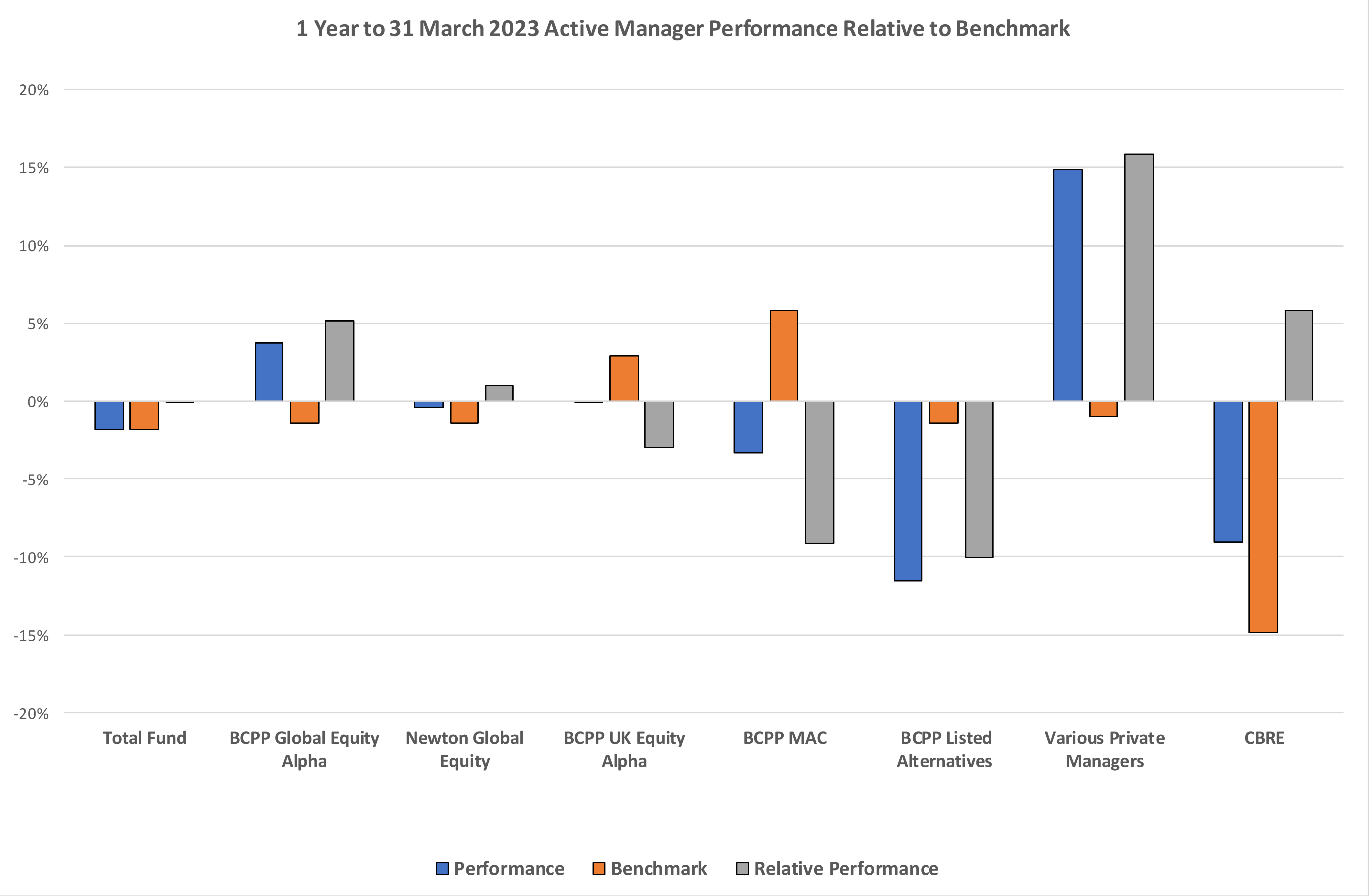
The table below shows manager performance for Q4 2022/23 (January-March 2023), net of investment manager fees, against manager specific benchmarks using Northern Trust data.

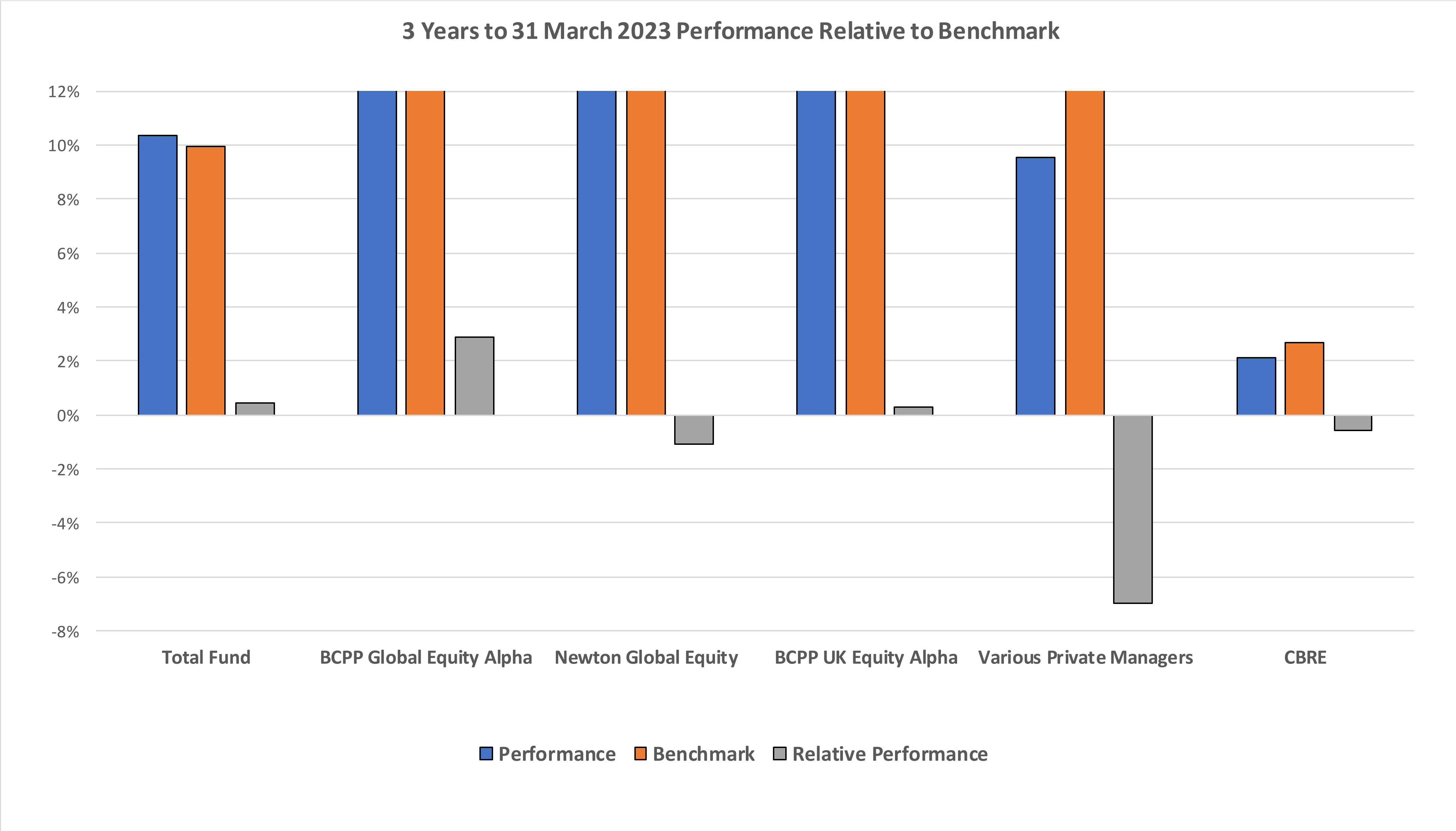
As at 31 Mar2023		3M				1Y				3Y		
Asset Class	£m	Performance	Benchmark	Relative Performance		Performance	Benchmark	Relative Performance		Performance	Benchmark	Relative Performance
Total Fund	**5,257.60***	3.39%	3.59%	-0.20%		-1.82%	-1.80%	-0.01%		10.36%	9.94%	0.42%
Active Global Equity	**1,230.5**											
BCPP Global Equity Alpha	739.5	6.51%	4.39%	2.11%		3.73%	-1.43%	5.17%		18.34%	15.47%	2.87%
Newton Global Equity	491.0	5.90%	4.39%	1.50%		-0.41%	-1.43%	1.02%		14.38%	15.47%	-1.08%
Active Regional Equity	**499.6**											
BCPP UK Equity Alpha	499.6	5.51%	3.08%	2.43%		-0.03%	2.92%	-2.96%		14.11%	13.81%	0.30%
Passive Global Equity	**925.7**											
LGIM - Future World Global	925.7	4.88%	4.99%	-0.11%		-1.03%	-0.74%	-0.29%				
Passive Regional Equity	**397.8**											
LGIM - Europe Ex-UK	51.6	8.75%	8.68%	0.07%		8.13%	7.64%	0.49%				
LGIM - FW Emerging Markets	11.1											
LGIM Emerging Markets	275.7	0.25%	0.14%	0.10%		-4.27%	-4.29%	0.02%		9.06%	8.98%	0.08%
LGIM - Japan	15.5	3.27%	3.12%	0.14%		1.97%	1.52%	0.45%				
LGIM - Asia Pacific ex-Japan	44.0	0.46%	0.43%	0.02%		-3.84%	-3.86%	0.02%				
Fixed Income	**689.8**											
BCPP MAC	563.6	2.72%	1.81%	0.90%		-3.32%	5.85%	-9.16%				
LGIM Gilts **	126.2	2.16%				-18.50%				-3.23%		
Private Markets Proxy	**250.7**											
BCPP Listed Alternatives	250.7	-0.87%	4.39%	-5.26%		-11.52%	-1.43%	-10.08%				
Private Markets	**795.2**											
Various Private Managers	795.2	-0.56%	4.81%	-5.37%		14.83%	-0.99%	15.82%		9.55%	16.51%	-6.96%
Real Estate	**307.8**											
CBRE	307.8	-3.64%	0.19%	-3.83%		-9.06%	-14.87%	5.81%		2.13%	2.69%	-0.56%
L&G Currency Overlay	22.6											
Total Cash & Equivalents	138.0											

* Includes £16.6m of money market funds

** Performance figures represent total Bespoke Fund (3M Gilt Return 2.93%, Liquidity Return 0.93%)


3 Months to 31 Mar 2023 Active Manager Performance Relative to Benchmark
10%
5%
0%
-5%
-10%
-15%
Total Fund
BCPP Global Equity Alpha
Newton Global Equity
BCPP UK Equity Alpha
BCPP MAC
BCPP Listed Alternatives
Various Private Managers
CBRE
Performance
Benchmark
Relative Performance


1 Year to 31 March 2023 Active Manager Performance Relative to Benchmark
20%
15%
10%
5%
0%
-5%
-10%
-15%
-20%
Total Fund
BCPP Global Equity Alpha
Newton Global Equity
BCPP UK Equity Alpha
BCPP MAC
BCPP Listed Alternatives
Various Private Managers
CBRE
Performance
Benchmark
Relative Performance


3 Years to 31 March 2023 Performance Relative to Benchmark
12%
10%
8%
6%
4%
2%
0%
-2%
-4%
-6%
-8%
Total Fund
BCPP Global Equity Alpha
Newton Global Equity
BCPP UK Equity Alpha
Various Private Managers
CBRE
Performance
Benchmark
Relative Performance

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Recent Transactions

17. In October 2021 the Fund purchased units in the BCPP Multi-Asset Credit Fund to a value of £613.5m. This was funded from the disposal of units in the Western Multi-Asset Credit Fund and units in the Templeton Global Total Return Fund.

18. In October 2021 the Fund purchased units in the LGIM Future World Global Equity Index Fund to a value of £996m. This was funded from the disposal of units in the LGIM RAFI Multi-Factor Developed Index Fund and units in the LGIM MSCI World Low Carbon Target Index Fund.

19. In February 2022 the Fund purchased units in the BCPP Listed Alternatives Fund to a value of £386.5m. This was funded from the disposal of units in the Baillie Gifford Diversified Growth Fund, units in the Aviva Investors Multi-Strategy Target Return Fund, and units in the Ruffer Absolute Return Fund.

20. From the second half of 2022 the Fund has used BCPP Listed Alternatives, BCPP UK Equity Alpha
8 and LGIM Liquidity Fund as a source of funds for private market capital calls.

21. As agreed in the December 2022 Committee meeting, a series of transactions are taking place. The emerging markets exposure of the Fund will move from a passive LGIM product to an actively managed BCPP product. Also, the exposure to UK equity will reduce and proceeds reinvested into LGIM FW Global. As at 31 March 2023, some of these transactions were in train.

Stock Lending

22. In the quarter to 31 March 2023, stock lending earned a net income for the Fund of £3,850 compared with £3,634 for the quarter ended 31 December 2022.

Mandate Change

23. During this quarter the investment management agreement with CBRE was amended. As discussed in the Committee meeting in December 2022, CBRE will now cease to re-invest returns of income and instead pay that income out to the Fund. Given the potential launch and Fund investment in the new BCPP real estate funds, and the potential lack of liquidity of some real estate investments, new investment commitments by CBRE will solely be made to (i) open ended funds, or (ii) funds with at least an annual redemption window.

24. The MAC Income Withdrawal plan has now been initiated with a monthly income of approximately £1.7m being returned to the Fund.

Asset allocation

25. The table and the graph below show the target and actual asset allocations for the quarter ending 31 March 2023. These allocations were agreed by the Pension Fund Committee in the December 2022 meeting.

	Total Fund (£M)	Actual (%)	Target (%)	Advisory ranges %	Role(s) within the strategy
Listed Equities		**58.1%**	**54.8**	**51.8 – 57.8**	Generate returns in excess of inflation, through exposure to the shares of domestic and overseas companies.
UK	499.6	9.5%	6.6		
Global Market Cap	1,230.5	23.4%	21.4		
Global Regional	111.1	2.1%	2.2		
Emerging Markets	275.7	5.2%	5.5		
Global Sustainable	936.8	17.8%	19.1		
Alternatives		**25.7%**	**27.6**	**22.6-32.6**	Generate returns in excess of inflation, through exposure to illiquid assets that are not publicly traded, whilst providing some diversification away from listed equities and bonds.
Private Equity	260.0	4.9%	5	2.0-8.0	
Private Infrastructure	381.4	7.3%	6	3.0-9.0	
Private Debt	127.9	2.4%	6	2.0-8.0	
Climate Opportunities	25.9	0.5%	3	0.0-6.0	
Listed Alternatives	250.7	4.8%			
Real Estate	307.8	5.9%	7.6	4.6–10.6	
Multi Asset Credit		**10.7%**	**12.1**	**9.1-15.1**	Offer diversified exposure to global credit markets to capture both income and capital appreciation of underlying bonds.
Multi Asset Credit	563.6	10.7%	12.1		
Fixed Interest Gilts		**2.4%**	**5.5**	**2.5-8.5**	Low risk income stream
Fixed Interest Gilts	126.2	2.4%	5.5		
Cash & Currency Overlay	160.6	**3.1%**			
Total	**5,257.6**		**100**		

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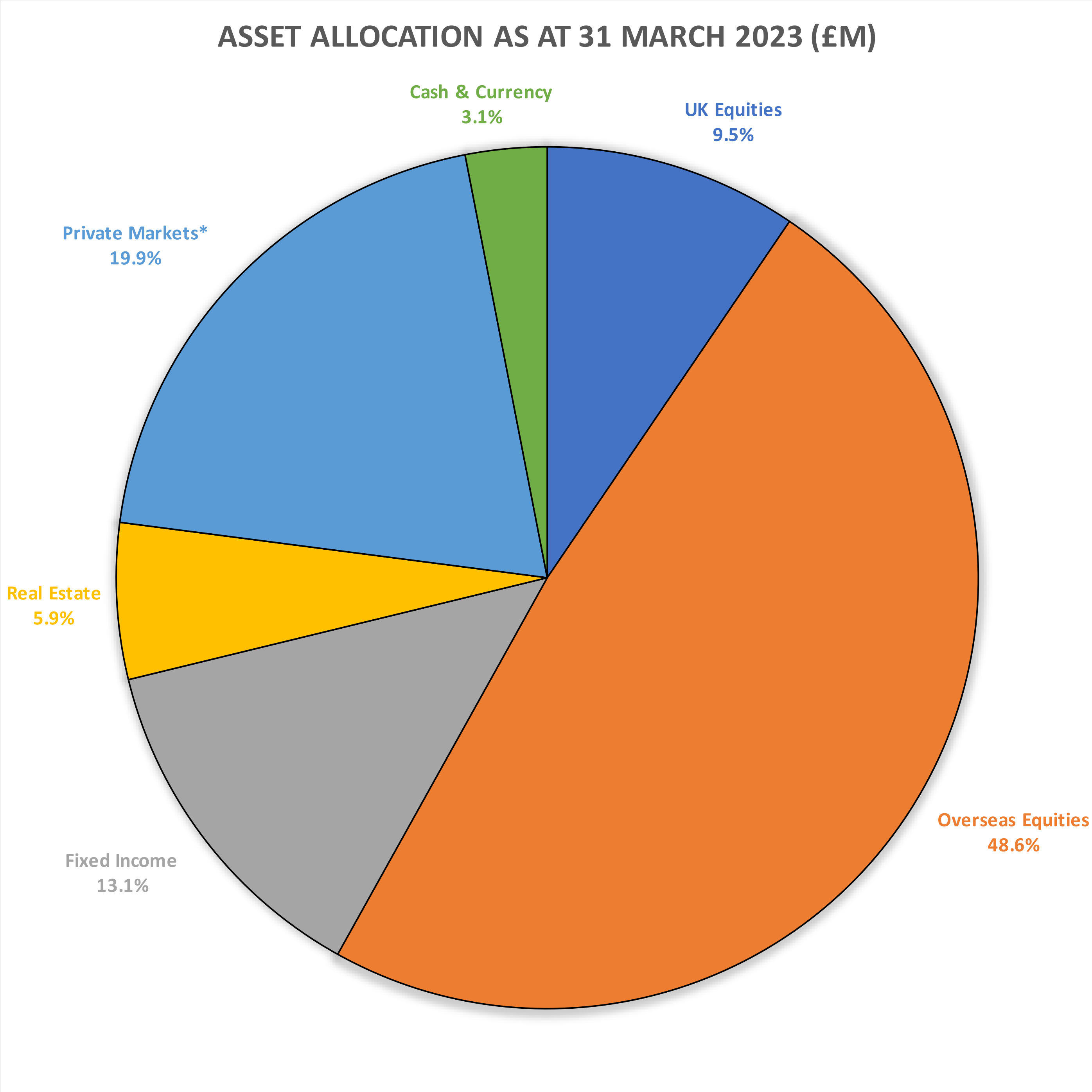
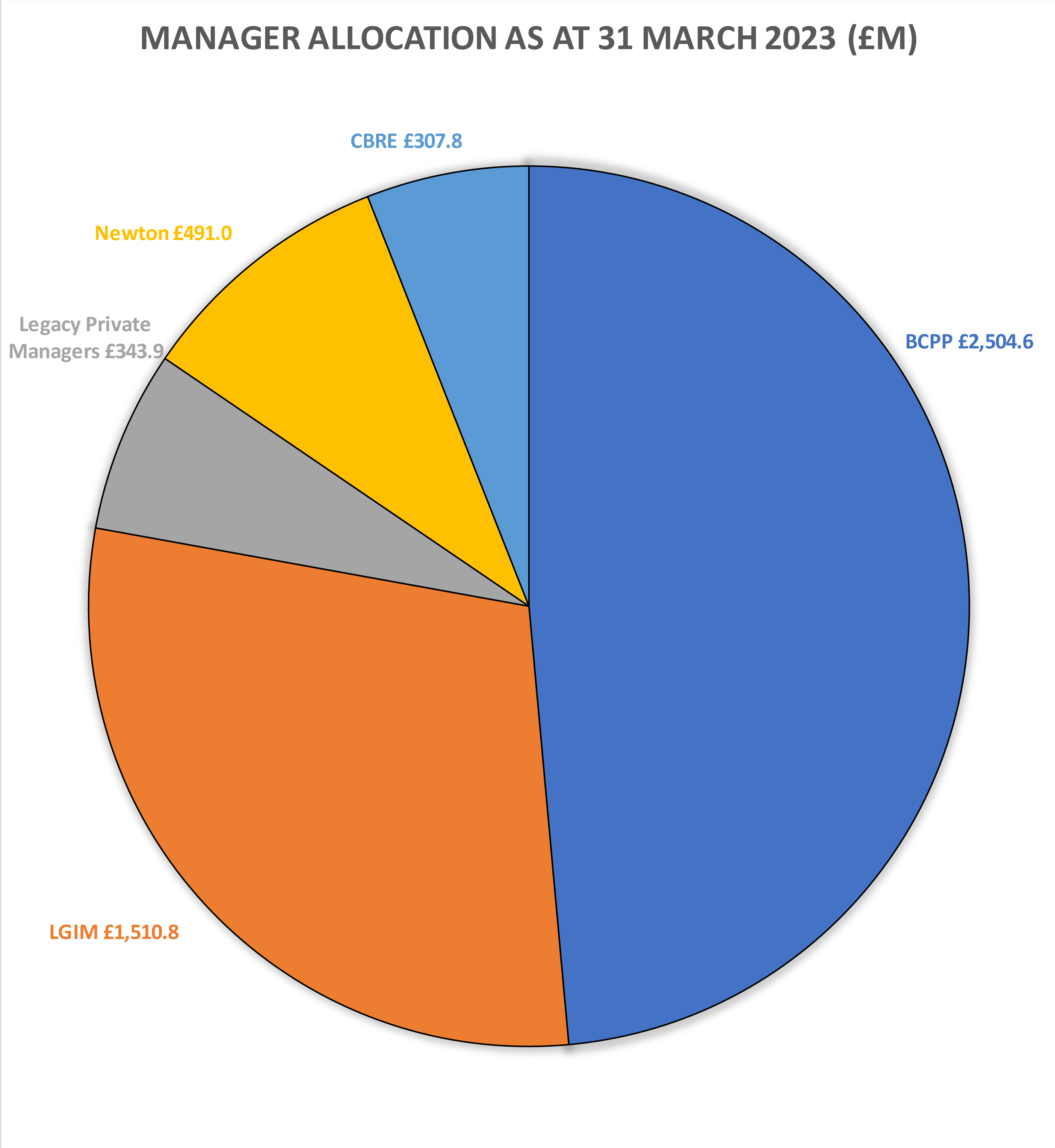
The graph below shows the asset allocation for the quarter ending 31 March 2023.



*Includes Listed Alternatives

The graph below shows the manager allocation for the quarter ending 31 March 2023.



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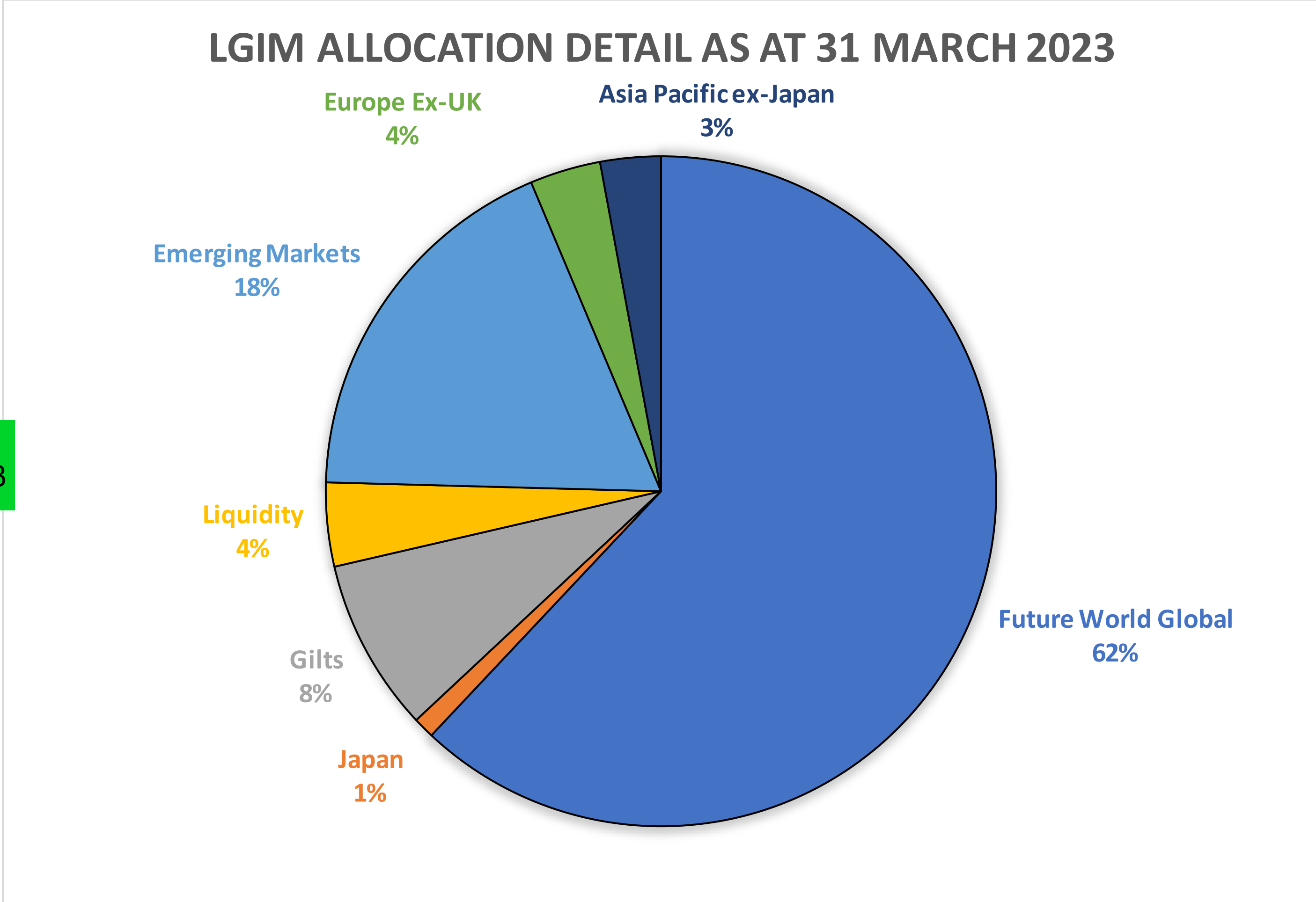
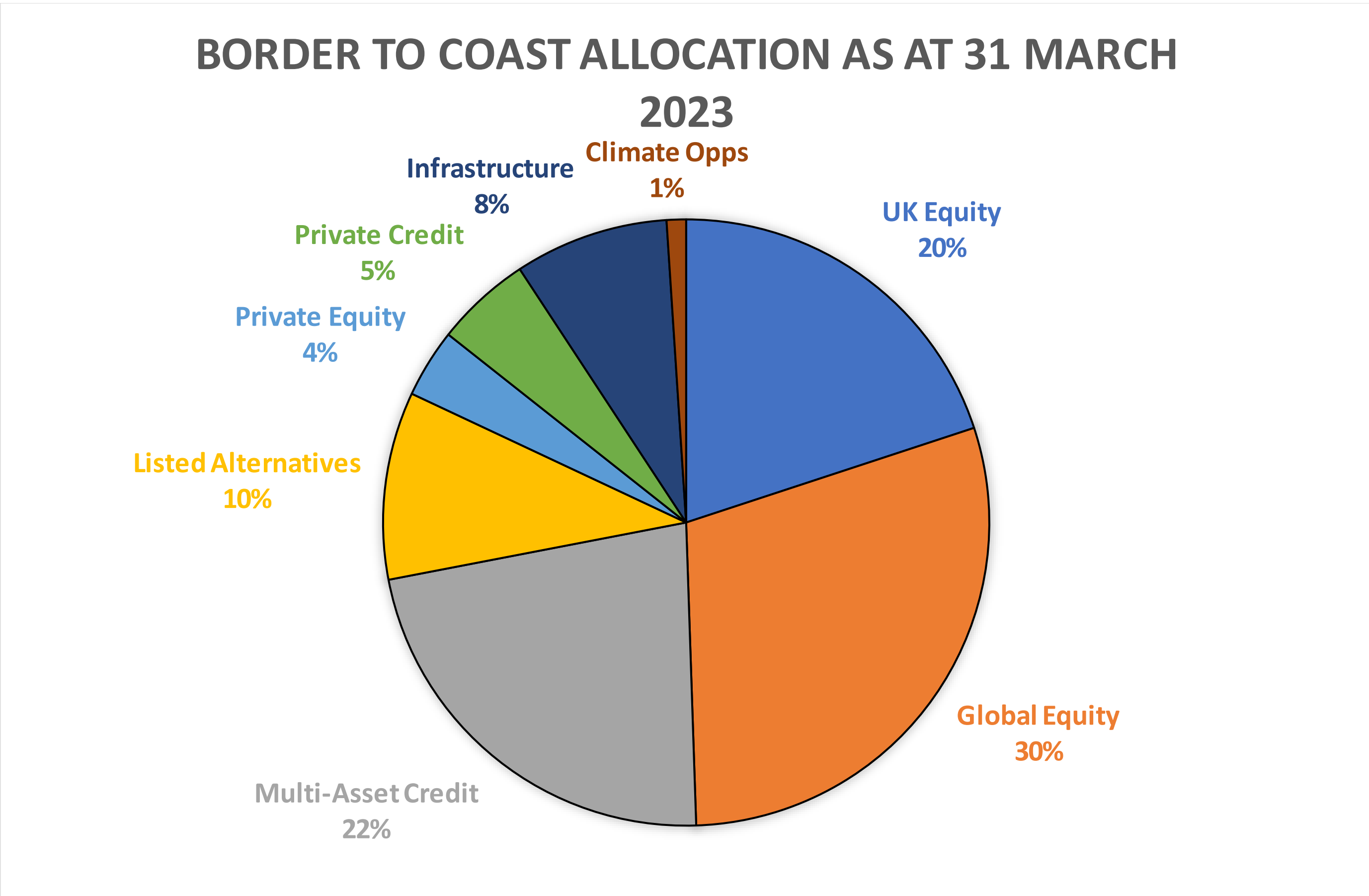

LGIM ALLOCATION DETAIL AS AT 31 MARCH 2023
Europe Ex-UK 4%
Asia Pacific ex-Japan 3%
Emerging Markets 18%
Liquidity 4%
Gilts 8%
Japan 1%
Future World Global 62%


BORDER TO COAST ALLOCATION AS AT 31 MARCH 2023
Infrastructure 8%
Climate Opps 1%
UK Equity 20%
Private Credit 5%
Private Equity 4%
Listed Alternatives 10%
Global Equity 30%
Multi-Asset Credit 22%

Cashflow

26. Contributions are derived from employers and employees. Pension benefits are derived from pensions and lump sum benefits paid to retired members and benefits paid to employees on leaving the Fund.

£m Period	Total contributions received	Total pension benefits paid	Net cash-flow
Quarter Three 2022/23 (1 Oct 2022 – 31 Dec 2022)	53.6	46.9	6.7
Quarter Four 2022/23 (1 Jan 2023 – 31 Mar 2023)	61.2	56.4	4.8

27. An indication of the current membership trends is shown by movements in membership over quarters three and four. Member data listed below.

Period	Active members	Deferred members	Pension members	Total members
Quarter Three 2022/23 (1 Oct 2022 – 31 Dec 2022)	35,473	43,744	30,482	109,699
Quarter Four 2022/23 (1 Jan 2023 – 31 Mar 2023)	35,531	43,203	30,742	110,476

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Fund Manager Benchmarks

Fund	Portfolio	Benchmark Index	Performance Target relative to Benchmark
Surrey Pension Fund	Total Portfolio	Weighted across fund	+1.0%

Manager	Portfolio	Benchmark Index	Performance Target relative to Benchmark
BCPP	UK Equities Alpha	FTSE All Share	+2.0%
BCPP	Global Equities Alpha	MSCI ACWI	+2.0%
BCPP	MAC	SONIA + 3.5%	
BCPP	Listed Alternatives	MSCI AC World Index	
Newton	Global Equities	MSCI AC World Index	+2.0%
Various	Private Equity	MSCI World Index	+5.0%
CBRE	Real Estate	MSCI/AREF UK QPFI All Balanced Property Fund Index (for UK Assets) Global Alpha Fund Absolute Return 9-11%	+0.5%
LGIM	Europe ex-UK Equities Future World Global Equity Index Japan Equity Asia Pacific ex-Japan Development Equity World Emerging Markets Equity Future World Emerging Markets Equity LGIM Bespoke & Cash	FTSE Developed Europe ex-UK Net Tax (UKPN) Solactive L&G ESG Global Markets Net FTSE Japan NetTax (UKPN) FTSE Developed Asia Pacific ex-Japan NetTax (UKPN) FTSE Emerging NetTax (UKPN) Solactive L&G ESG EM Equity Fund return	To track the performance of the respective indices within a lower level of tracking deviation (gross of fees) over rolling 3-year periods

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CONSULTATION:

28. The Chair of the Pension Fund Committee has been consulted on this report.

RISK MANAGEMENT AND IMPLICATIONS:

29. Risk related issues have been discussed and are contained within the report.

FINANCIAL AND VALUE FOR MONEY IMPLICATIONS

30. Financial and value for money implications are discussed within the report.

DIRECTOR CORPORATE FINANCIAL & COMMERCIAL COMMENTARY

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31. The Director Corporate Financial & Commercial is satisfied that all material, financial and business issues and possibility of risks have been considered and addressed.

LEGAL IMPLICATIONS – MONITORING OFFICER

32. There are no legal implications or legislative requirements.

EQUALITIES AND DIVERSITY

33. The approval of the various options will not require an equality analysis, as there is no major policy, project or function being created or changed.

OTHER IMPLICATIONS

34. There are no potential implications for council priorities and policy areas.

WHAT HAPPENS NEXT

35. The following next steps are planned:

a) Continue to implement equity asset allocation restructure as agreed in the Committee meeting in December 2022.
b) Continue transition into BCPP EM Equity Alpha
c) Continue to monitor performance and asset allocation.

Contact Officer:
Lloyd Whitworth, Head of Investment & Stewardship

Consulted:
Pension Fund Committee Chair

Annexes:
1) Annexe 1 - Manager Fee Rates (Part 2)

Sources/background papers: None

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